SECURITISATION – FINANCIAL SECTOR REFORM IN EMERGING MARKET: STRIKING A BALANCE BETWEEN ENHANCING CREDITORS RIGHT BY SECURITISING NON-PERFORMING LOANS AND CATALYZING RECESSION

Guided By:

DR. VISHWAS H DEVAIAH

Submitted By:

SHYAMTANU PAL

PHD. RESEARCH PROGRAMME – 2011

WEST BENGAL UNIVERSITY OF JURIDICAL SCIENCES

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- ***INTRODUCTION***

In order to make its presence felt throughout the globe, it is pertinent for any country to be economically self sufficient and the self sufficiency to its maximum extent depends upon the growth of the banking institution within that country. The more smooth and efficient the banking sector will function, the sooner a country will lead itself towards a prosperous tomorrow. The banking sector in India is growing and its escalation has contributed substantially in the progress of the country's financial market. The lending and borrowing system form the foundation from which the banks and financial institutions derive their profits. Lending is thus part and parcel of the banking industry.

The development of Indian economy after experiencing the 'globalization of opportunities' has brought in new participants[1] in the financial sector, and along with these new participants, "growing capital mobility"[2]. Simultaneously, regulators around the globe continued their efforts to ensure the health and stability of world banking and financial systems in hopes of ensuring economic development for the third world. However, partly as a result of the financial crises that ravaged countries worldwide[3], developed economies and 'emerging markets'[4], the

[1] See, Daniel Yergin & Joseph Stanislaw, The Commanding Heights: The Battle Between Government and the Marketplace That Is Remaking the Modern World (1998); The Commanding Heights: The Battle for the World Economy.

[2] See,Lawrence Sáez, Banking Reform in India and China, 6 Int. J. Fin. Econ. 235, 235 (2001).

[3] E.g., U.S. savings and loans debacle, the Chilean banking crisis of the 1980s, the Argentine and Mexican crises in the mid-1980s and 1990s, as well as the Asian financial crisis in 1997, which brought worldwide turmoil.

[4] The term "emerging markets" has become somewhat ubiquitous in the financial literature. What is meant by "emerging" in such "emerging markets" is, however, unclear. Some commentators argue that emerging markets are

policymakers started rethinking their approach to economic development[5]. In particular, the Asian financial crisis that affected Southeast Asia brought to the forefront weaknesses in the banking sector of Southeast Asia[6] and the issue of banking reform. This also changed the priorities for the policymakers as they realized that micro- and macro-economic conditions were equally important in a globally connected economy[7], and reforming international financial systems was essential for global economic well-being[8]. The Asian financial crisis also provided a glaring example for the Chinese and Indian economies to correct course and set into motion policy changes that could help them avert a similar disaster. Although China and India were spared in this crisis[9], there was a realization that Chinese and Indian banking sectors faced

instead "re-emerging" markets. See, e.g., William N. Goetzmann & Philippe Jorion, Re-Emerging Markets, 34 J. Fin. & Quantitative Analysis 1, 1-2 (1999) ("Markets tend to emerge, submerge, and re-emerge through time ... many of today's emerging markets are actually re-emerging markets"); Emerging Economies: Climbing Back, Economist, Jan. 21, 2006, at 69, 70 ("The growing clout of emerging economies is in fact returning them to the position they held for most of history."). In any event, the term which was coined by the International Finance Corporation, see id., is used to define "[financial] markets in developing countries (low- and middle-income economies)." E. Han Kim & Vijay Singal, Stock Markets Openings: Experience of Emerging Economies, 73 J. Bus. 25, 28 n.7(2000). This definition has become the basis of common usage of the term "emerging markets" across the board.

[5] During first half of the 1990s, "Washington consensus" came into vogue. Coined by John Williamson of the Institute for International Economics, it roughly meant that "free markets and sound money," Paul Krugman, Dutch Tulips and Emerging Markets, Foreign Aff., July-Aug. 1995, at 28, 29, were the key to economic development. The Mexican crisis in 1994 discredited the consensus, however. See id. at 31. For a brief discussion of the "Washington consensus," see Center for International Development at Harvard University, Global Trade Negotiations Homepage, Washington Consensus, http:// www.cid.harvard.edu/cidtrade/issues/washington.html

[6] The Asian financial crisis, or Asian Contagion, as it is popularly called, Sebastian Edwards, Contagion (Revised Version of 1999 World Economy Lecture, University of Nottingham, Oct. 28, 1999) (2000), available at http:// www.anderson.ucla.edu/faculty/sebastian.edwards/world&uscore; economy5.pdf, has been described as one of "the most serious financial crisis in a half a century.

[7] Dilip K. Das, Asian Crisis: Distilling Critical Lessons 11 (United Nations Conf. on Trade & Dev., Discussion Paper No. 152, 2000), available at http://www.unctad.org/en/docs/dp_152.en.pdf.

[8] See Stanley Fischer, Financial Crises and Reform of the International Financial System (Nat'l Bureau of Econ. Research, Working Paper No. 9297, 2002).

[9] As Mr. Jim O'Neill, see dagger footnote, remarked upon reading an earlier draft, "why did India avoid the Asian crisis?" is an important question. Email from Jim O'Nell, Managing Director & Head of Global Economic Research, The Goldman Sachs Group, Inc., to Anshu S. K. Pasricha, Editor-in-Chief, Buffalo Law Review (Nov. 29, 2006, 04:34:00 EST) (on file with the Buffalo Law Review). That perhaps because of the shorter time duration since the financial liberalization had started in earnest in India, by 1997 there was not enough "flighty" investment in Indian economy so as to affect it as brutally as it did Thailand and other countries. It is also possible that the Indian banking system--because regulatory reform had not yet been completed-- was still under the strict foreign exchange regulatory regime, and was therefore immune to a certain extent to such exogenous shocks.

problems similar to those faced by the Southeast Asian economies during the build-up to the Asian crisis[10].

The problems that afflicted the Indian banking sector in particular were predominantly a result of decades of "directed credit" policies of successive Indian governments[11]. During much of the second half of the twentieth century, the Indian banking sector had characteristics of social control[12]. The supposed role the banking sector played in the economy was that of providing financial support for preferred sectors, which would purportedly lead to development of the country[13].

However, because of inefficient lending practices, combined with poor monitoring and even corruption adding on to a certain extent, the Indian banking sector became saddled with huge bulk of non-performing loans. In fairness to Indian policymakers, they realized the weaknesses in their banking sector before the Asian financial crisis, and had already instituted committees for understanding the problem[14]. However, the Asian financial crisis only served to increase the urgency in the Indian policy circles.

[10] Although primary focus here is on the non-performing loans in the banking sector there is yet another set of pertinent issues always in the subtext: the issue of Asian economies' over-dependence on the banking sector in the course of economic development. Most Asian economies, especially those of China and India, enjoy a very high savings rates. Households continue to save almost a third of GDP, on an average, across Asia. These are "lent on" by the banks, and to make a logical jump, as such discussion is beyond the scope of this Comment, there is under-utilization of capital markets. To put things in perspective, the average size of bond markets in Asia remained under twenty percent of regional GDP, while that of United States is over hundred percent of GDP. Result of such reliance on the banking sector is a high-leverage financial structure that cannot absorb exogenous shocks--and perhaps even endogenous ones--efficiently, resulting in crises. This implies that among other things, a strong debt market is helpful in strengthening the economy.

[11] Such directed credit policies were perhaps necessary in the predominantly rural economy so as to provide the small farmers with funds necessary to support their farming ventures.

[12] The policy was formally announced only in 1967.

[13] The financial system in India--at least in the latter half of last century--depended heavily on the development finance institutions, which provided financial assistance to large and small industrial concerns. Leading development finance institutions in India were, and continue to be, the Industrial Finance Corporation of India, Industrial Development Bank of India, and the Industrial Credit and Investment Corporation of India (now ICICI). In addition, the Small Industries Development Bank of India, SIDBI, was created in 1989 to provide "financial assistance leading to the promotion, financing, and development of small-scale projects and microenterprises."

[14] See P. K. Bhattacharjee, NPA Management - Perform or Perish, Chartered Fin. Analyst, Oct. 1999, at p.51

Besides some of the structural problems, there were institutional difficulties. For example, in 1993, in response to the recommendations of the Narasimham Committee 1991 Report the Parliament had enacted Recovery of Debts Due to Banks and Financial Institutions Act, 1993. This Act created a separate apparatus in the order of Debt Recovery Tribunals which were devolved with the responsibility of administering disputes pertaining non-payment of debts and for initiating speedy recovery proceeding by banks. However this system was not satisfactory as the convulsion of those real estates and translation into liquid assets seemed impossible because of the legal complexities as well as the sloth of our judicial system. It meant that bad debt of the banks and financial institutions ran into huge bulk of rupees which would not be recovered easily due to delays in the conventional legal system. It took years for the banks to liquefy the security assets and appreciate the sum of deficiency. This resulted in blockade of huge amounts causing unhealthy economic imbalances in the functioning of banks and financial institutions.

However, the performance of DRTs was highly unsatisfactory because of various impediments. One such impediment was the Sick Industrial Companies (Special Provisions) Act 1985 (SICA). The banks found it extremely difficult to sue for recovery of money against an industrial entity registered as "sick" under SICA. Apart from that, consent was also required from the Board for Industrial and Financial Reconstruction (BIFR), created under article 4 of SICA, for the process of recovery. These vestiges of the "license raj" era of socialist India were an anachronism in the fast-changing world of the liberalized Indian economy and were being used by defaulting companies to their advantage. Fortunately, the Government of India realized that drastic steps were required to expedite the recovery of NPAs, and therefore a bill abolishing SICA, the Sick Industrial Companies (Special Provisions) Repeal Bill was introduced in the Lok Sabha on August 30, 2001. In addition, another bill the Companies (Amendment) Bill of 2001 was also introduced in the Lok Sabha to bring about changes necessary to expedite the recovery of bad loans. Although the bills were presented amid much fanfare, only the Companies (Amendment) Act was passed in 2001; the other languished in the parliamentary system until 2003 when the Sick Industrial Companies (Special Provisions) Repeal Act finally became law.

Amidst all this, performance of Public Sector Banks continued to be adversely affected, partly as a result of the delicate political economic structure of India, partly because of competition from foreign banks, and partly because of inherent structural deficiencies. This built up a sense of urgency in the Indian bureaucratic and political circles. All the frenetic activity and public debate over NPAs resulted in a rather drastic step, the promulgation of "The Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002" (SARFAESI), by the Government of India. Suddenly, there was an enhancement of creditors' rights, which empowered "banks and financial institutions to take possession of the securities and sell them without going through the protracted judicial process."

In wider sense securitisation implies every such process that converts a financial relation into a transaction, more specifically, into a capital market instrument or security. It is a process through which illiquid assets are packaged, converted into tradable securities and sold to third party investors. In securitisation process there are mainly two crafts**:** the original lender and a Special Purpose Vehicle (SPV). The SPV helps the original lender in liquefying the assets. The SPV converts these assets into marketable securities for investment and the cash flows to the original lender. This helps the original lender in meeting up the deficiency which arose out of the borrowers default. Apart from original lender and SPV, other parties involved in securitization process are merchant or investment banker, credit rating agency, servicing agency and the buyers of securities.

In this present era of economic growth and financial independency, the individual economies are striving hard in order to achieve global economic order and interlinking. The Indian banking sector is not an exception to it. The banking sector being a part of the financial sector, the Indian banks are equally motivated to accomplish international standards. Accordingly to achieve this objective securitising the liabilities of banks is a good option. Therefore, in this regard it must be admitted that the ratification of Securitisation Act is a positive step taken in the right direction.

As far as India is concerned the advantages that securitization of loans may accrue is interesting. In an economy which is growing and in need of more capital, securitization helps in managing the limited capital efficiently. The commercial banks can reallocate their risks in a planned manner improving their credit and operating system. The investors are in a never-ending enthusiasm for having more assets and this hunger can be bespoken by asset securitisation. By securitizing a class of assets a bank can reduce its capital costs by avoiding capital adequacy requirements. This is because the issue of securities against securitised assets no longer allows these assets to appear in the balance sheet of the originator. Thus the originator is not required to hold capital and reserve against these assets which lead to the reduction in overall cost of capital by securitisation. In short this system can prove to be a vehicle for the augmentation or increase of domestic savings as well as attracting overseas investments which might be imperative in the infrastructural enlargement of the country.

The process of securitisation of loans has led India to witness a vogue in the banking sector. This fashion or trend may be termed something like belligerent, aggressive, innovative and proactive banking. This is presently the open truth of the banking sector. This is so because banks earn profit mainly form loans and lending involves a great deal of risk. Before providing loans the banker has to think twice, take a lot of factors into contemplation and apprise a lot of things, as there is always an atmosphere of worry about the repayment of these loans. Adding to that these banks also needs to be accountable to the central bank, because these institutions deal with the public money. But with the surfacing of securitisation of loans there is a feeling of security in the banking sector and it has tutored the banks not to behave like their traditional brothers and to expand instead. The driving force behind this changing concept is loans being treated like tradable securities to be packaged, sold and forgotten about. In this way securitisation has emerged as the as the engine room of the financial market.

Form the above forethought one may come to the outlook that securitisation of loans is all right and there is no dilemma in the process. However if analyzed in a different manner then there is one potential dilemma. This dilemma comes when we think about securitization not from

the perspective of individual financial institution but from the standpoint of the financial system as a whole. We have already discussed previously that now a day isolationism has no place to function and hence things to be considered globally. Thus the debate in which we partake is not from the point of view of our own financial system but the universal one. This is because our country has already made a takeoff from isolationism and in the process of being more integrated with the global economic order. Therefore when one scrutinizes the concept of securitization of loans then he/she may face with the difficulty as to securitisation of what, the individual institutions or the financial system as a whole.

The securitisation of loans facilitates the original lender thinking that he is sticking to an opportune position which will abet him to transmit the jeopardy to the other investors and with this process the originator can getaway capital sufficiency requirements**.** But the hazard which securitisation wants to avoid does not disappear from the financial system altogether. The securitization or reconstruction companies which buy and invest the securities engage themselves in a highly risk prone business and hence they have to highly depend again on the commercial banks for the supply of the required credits. Therefore incongruously the commercial banks are again driven to foster the business of these investors which undertake a risky game. Thus an unseemly assessment of risk may result the peril might knock the door of the originator once again. For this reason the risk does not ebb from the system on the whole and in the natural course of financial market the same may trouble again. Therefore the disease that securitisation wants to cure remains as it is and merely changes its position from one to another actor in the market. This has been discussed elaborately hereinafter.

We need to bear in mind that there is always a risk attached to this concept, the glaring example is that of America where the main cause of the "Great Recession" was the unraveling of the mortgage securitization industry beginning in 2007. What had been a relatively small functioning market at the beginning of the 1990s, was transformed into the core activity of the financial sector of the American economy from 1993-2007. In 2003, the financial sector was generating enormous amount of the profits in the American economy and these profits were mostly being made from businesses centering on and related to the selling of mortgages and the

creation of various forms of mortgage backed securities and related financial products. This mortgage business represented a quarter of the American economy. But subsequently during the late 2006 and early 2007, there was a breakdown in the financial sector. That crisis threatened the existence of the entire banking system in America. As banks panicked, the system of granting access to short and long term credit for both businesses and consumers threatened to shut the economy down. In response to this uncertainty, consumers and businesses stopped buying. This created a downward spiral in the economy and the most severe crisis in American capitalism since 1929 rapidly took hold.

▪ REVIEW OF LITERATURE.

- ***VINOD KOTHARI, "Securitization Asset Reconstruction and Enforcement of Security Interests" Lexis Nexis Butterworths Wadhwa Nagpur, 3rd Edn. 2010***

  Even though being one of the best existing literatures on securitization but there are some areas which the author has failed to touch down. The problem of non -performing loan which has emerged as a global problem has not been dealt exhaustively. Moreover it has failed to discuss on the global financial crisis, its reasons impact on the Indian economy. The literature definitely explains the significance of securitization as a financial instrument and also how these banks are engaged in transforming loans and lending risks into capital market securities and selling the same. Thus, the researcher through this research will try to find answers to those unexplored areas.

- ***Dr .R.G.CHATURVEDI, "Law of Practice Of Securitization And Reconstruction Of Financial Assets And Enforcement Of Security Interest" Bharat Law Publications, Jaipur***

  The concerned book provides a beautiful commentary on a complex enactment which is a blend of several sophisticated concepts. This book has elaborated the concept of securitization in a very thought through way and has also painstakingly discussed the entire procedure of enforcement of security interest etc. But, there is no evidence to show that the said book talks about the relationship between the recession and securitization.

- ***T.K.A. PADMANABHAN, Securitization and Reconstruction of Financial Assets, Concepts Law and Practice, Company Law Institute of India Pvt. Ltd Chennai.***

This publication is definitely a relevant one because the author has certainly jotted down the concept and essentials of asset securitization with an overview of the provisions of the Securitization Act along with the relevant facts. But what it lacks is the discussion of securitisation with reference to the global perspective and the scope and position of the securitisation at international level.

- ***JUSTICE B.P. BANERJEE, "Guide to Securitisation Reconstruction of Financial Assets and Enforcement of Security Interest", Wadhwa and Company Nagpur.***

This book is a humble attempt by the author to present the concept related to securitization, its enforceability and has narrated the concept whether Indian experience is limited in the field of securitization or it has some relevance in the global perspective. It is very pertinent to discuss the issues or the reasons behind the huge financial crisis and the impact it had on Indian capital market. Thus this existing literature provides with no such conversation related and the said issue is unexplored. Thus through this work the researcher will try to elaborate more on this topic.

- ***ALASTAIR HUDSON , "Securities law" , Sweet and Maxwell London***

This is a kind of publication where the author has briefly explained the nature of security market, fundamentals of security law and regulations, practice in the securities market and alternative investment market etc. But the work fails to discuss certain vital issues which relates to the regulators of the market. The researcher through his present work will try to analyse the responsibility and role of the market regulators in such a situation wherein securitization has resulted in recession or has contributed to it.

- ***SRIVASTAVA, "Securitization and Debt Recovery Laws," Law Publication India Ltd.***

The concerned book relates with respect to the debt recovery laws in India. Under this book the basic concept of bad debts and demand for its cure has been provided. He has beautifully mentioned that how increase in bad debts urged the Govt. to think of an Act which could prove fruitful for its recovery and ultimately resulted in SARFESI Act. But the need of the hour is to go further ahead and critically analyse the existing loopholes, the practical problems with regards to the implementation of the provisions of the Act. Not only that, it is also very essential to uncover that whether the objective behind the creation of securitisation is truly fulfilled. Therefore the researcher will look forward to answer these questions through this research work as it has not been talked about anywhere.

▪ *BACKGROUND OF THE WORK*

1) SECURITISATION AND RECESSION – UNDERSTANDING THE TERMS

Securitisation.

Securitisation is the process of converting something into a security, that is to say, when something that is not a security is converted into one, it is securitisation. A "security" is a capital market instrument, e.g. if the cash flow on account of hiring of the car were converted into a security and this security were to be offered in the capital market, we have securitized the cash flows, or securitised the asset . Thus, securitisation is the process that transforms an asset into a security, and the security that results is typically called an "asset backed security". [15] In other words, it is the polling in of assets which have an income stream and the repackaging of such assets in the form of marketable securities for sale to the investors. The securities are secured by the assets themselves or by the income derived by them. In widest sense it implies every such

[15] *Vinod Kothari* , Securitization Asset Reconstruction And Enforcement Of Security Interest ,(2010) at p.06

process that converts a financial relation into a transaction, more specifically, into a capital market instrument or society.

The sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets and to ensure that such interests are more readily marketable and, thus, more liquid than ownership interests in and loans against the underlying assets.[16] Securitisation of assets as a financing tool has come a long way since the 1970s when the first securities backed by residential mortgages were introduced in the United States debt markets. Although technically, securitisation existed in some form before the modern securitized products, it is principally an American financing technique. In its early years, securitisation was almost always used to finance relatively simple, standardized, and self-liquidating assets such as mortgage loans; today securitisation has expanded in both its applications and in its global outreach. Securitisation of a variety of cash flows is now frequently employed in more complicated financing structures around the world. Securitisation, amidst all this frenetic activity surrounding it, however, still remains largely an innovation.[17]

Under SARFAESI, if a loan becomes non-performing, the secured creditor may, by

[16] Asset-backed securities are securities that are backed by a discrete pool of self-liquidating financial assets. Asset-backed securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into instruments that may be offered and sold in the capital markets. In a basic securitization structure, an entity, often a financial institution and commonly known as a 'sponsor,' originates or otherwise acquires a pool of financial assets, such as mortgage loans, either directly or through an affiliate. It then sells the financial assets, again either directly or through an affiliate, to a specially created investment vehicle that issues securities 'backed' or supported by those financial assets, which securities are 'asset-backed securities.' Payment on the asset-backed securities depends primarily on the cash flows generated by the assets in the underlying pool and other rights designed to assure timely payment, such as liquidity facilities, guarantees or other features generally known as credit enhancements. The structure of asset-backed securities is intended, among other things, to insulate ABS investors from the corporate credit risk of the sponsor that originated or acquired the financial assets.

[17] Although securitization, as we know it, is almost three decades old, the frontier is rapidly changing. To put things in perspective, the Securities and Exchange Commission came out with a comprehensive set of regulations aimed at "addressing comprehensively the registration, disclosure and reporting requirements for asset-backed securities" only recently. Further, in countries like India, it is only in the past few years that the use of securitized products has gained momentum. Securitization is still in its nascent stages, with securitized assets as low as about 2% of all debt outstanding.

providing a notice of sixty days, become entitled to exercise the rights available to it under SARFAESI.[18] SARFAESI provides that upon receiving such notice, if the borrower fails to discharge its liability in full, the secured creditor may take possession of the secured asset, or may take over the management of the secured asset by appointing a manager. According to the RBI guidelines, an asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.[19] A NPA is further defined as an advance where:

- interest and/or installment of principal remain overdue for a period of more than 180 days in respect of a term loan;
- the account remains "out of order" for a period of more than 180 days;
- the bill remains overdue for a period of more than 180 days in the case of bills purchased and discounted;
- interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes; and
- Any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

Securitisation is thus a financial practice of pooling various types of contractual debt such as residential mortgages, commercial mortgages, auto loans or credit card debt obligations and selling said consolidated debt as bonds, pass-through securities, or Collateralized mortgage obligation (CMOs), to various investors. The principal and interest on the debt, underlying the security, is paid back to the various investors regularly. Securities backed by mortgage

[18] Where any borrower, who is under a liability to a secured creditor under a security agreement, makes any default in repayment of secured debt is classified by the secured creditor as non-performing asset, then the secured creditor may require the borrower by notice in writing to discharge in full his liabilities to the secured creditor within sixty days from the date of notice failing which the secured creditor shall be entitled to exercise all or any of the rights under sub-section (4). Sec.13(2).

[19] RBI,"Prudential norms on income recognition, asset classification and provisioning--pertaining to advances", Circular, August 30, 2001.

receivables are called mortgage-backed securities (MBS), while those backed by other types of receivables are asset-backed securities (ABS).

Despite the complexity of present day securitisation structures, a typical securitisation deal involves a firm (Originator) identifying and selling its rights to receive certain future monies (Receivables) to a special purpose entity. By isolating these assets from the selling entity and transferring the assets to a special purpose vehicle,[20] the Originator can obtain present cash flow. This special purpose vehicle then issues marketable securities, usually bonds, which are most certainly rated higher than the debt of the entity selling the assets to the special purpose vehicle. Depending upon the performance characteristics of the underlying assets, various credit enhancements may be used so as to assure the investors of the returns associated with these securities.[21] One key issue in these transactions is to ensure that the transfer of assets results in isolation of the assets from the seller and that these assets do not recourse back to the seller in the event of bankruptcy.

In simple terms, securitisation is a device of structured financing wherein an entity i.e. the originator pools together its interests in identifiable cash flows over time and transfers the same to investors thereby achieving the purpose of financing[22]. As the definition points out, the said process involves market based trading and therefore it requires an entity which can transform such interests into marketable securities. This transformation is brought about by Special Purpose Vehicles (SPV) or Special Purpose Entities (SPE), created by the originator for the same. The process of securitisation is initiated by the originator, wherein a pool of assets is created and a legal sale of the same is executed to the SPV, which may be a trust or a company setup to carry out its restricted purpose . The SPV now issues asset backed tradable securities based on the ratings assigned by credit rating agencies and then sells them to investors. Finally the SPV uses the proceeds of these transactions to pay the originator

[20] An originator or sponsor may create a legal entity, an SPV (sometimes referred to as a special purpose entity (SPE)), by transferring assets to the SPV to carry out some specific purpose, circumscribed activity, or a series of such transactions.

[21] In an ABS transaction, it is necessary for the issuer to satisfy the purchasers of the credit quality of the securities. Credit enhancements are provided by the sellers for this particular purpose.

[22] *Clifford Gomexz*, Financial Markets: Institutions and Financial Services, Phi Learning Pvt. Ltd, 448 (2010)

for the purchase of the pool of assets. Therefore, the process of Securitisation comprises a complex bundle of the rights and liabilities of the said stakeholders.[23]

It involves several participants with each carrying out specialized functions. These include an originator i.e. owner of the asset at the outset[24]; a SPV that issues the debt or equity instruments; investment bankers who assist in structuring the transaction and who underwrite or place the securities; credit rating agencies, which provide an objective estimate of the credit risk, by assigning a credit rating; a credit enhancer, possibly a bank, surety company, or insurer, who provides credit support through a letter of credit, guarantee, or other assurance that there will be a source of funds available for payments as they become due on the securities; a servicer, who bears all administrative responsibilities, a trustee, who deals with the credit enhancer, servicer, and issuer on behalf of the security holders; a regulator looking after the adequacy of capital, liquidity and the quality of credit of the said asset backed securities; and specialist functionaries such as legal and tax counsels, accounting firms and pool auditors.[25]

Importance of securitisation

Some of the main advantages of securitisations are:

- It provides liquidity to the originators (non –banking financial companies/ banks) because it is concerned with the conversion of illiquid assets into liquid assts. The originator gets lump sum amount of money from the SPV or the trust to carry out its operations smoothly and in the absence of it, this money is to be realized in installments over the years from the borrowers.[26]

[23] *Gary Gorton, Nicholas Soules,* Special Purpose Vehicles and Securitization, Working Paper 11190, National Bureau of Economic Research, 1 (2005)
[24] *Steven L. Schwarcz,* the Alchemy of Asset Securitization, 1 Stan. J.L. Bus. & Fin. 133, 135 (1994)
[25] *G. Shiva,* Securitization of Debt, 203
(retrieved from http://www.iief.com/Research/debt_chp21.pdf on 26.03.2012)
[26] *P.K.Malik,* Securitisation of Financial Assets: Status, Problems and Prospects.

- Securitized debt is cheaper and with this deal the originator can beat the ratings given by the rating agencies and diversify the credit risk and
- Originators can plan their capital adequacy requirements by using securitization to reduce the risk weighted assets. These are requirements relating to minimum regulatory capital for financial intermediaries. Thus it allows the financial entity to sell off some of its on-balance-sheet assets thereby removing them from the balance sheet which ultimately results in reduction of in the amount of capital required for the regulatory purposes.

Recession, its impact and factors responsible.

This term needs no introduction yet is no official definition of recession. But there is general recognition that it refers to a period of decline in economic activity. Very short periods of decline are not considered recessions. Most commentators and analysts use, as a practical definition of recession, two consecutive quarters of decline in a country's real (inflation adjusted) gross domestic product (GDP)-the value of all goods and services a country produces.[27]

The National Bureau of Economic Research (NBER) uses a broader definition and considers a number of measures of activity to decide the dates of recessions. It defines recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches its trough.

For more than a year, barely a day has passed that we have not heard dreadful economic news about the United States, Europe, or Japan. Unemployment has been rising, company profits have been falling, financial markets have been tumbling, and the housing sector has been collapsing. This is what we called as "recession. The ongoing global financial crisis has been accompanied by recessions in many countries. This pattern is consistent with the historical

[27] *Stijn Claessens and M. Ayhan Kose*, Basics of recession
(retrieved from www.imf.org/external/pubs/ft/fandd/2009/03/pdf/basics.pdf)

record. Synchronized recessions have occurred in advanced economies several times in the past four decades- the mid-70s, early 80s, early 90s, and early 2000s. Because the United States is the world's largest economy and has strong trade and financial linkages with many other economies, most of these globally synchronized recession episodes also coincide with U.S. recessions.

After 1997-98 crises, the Asian economies started to buy the U.S. securities. This led to dispense of dollars into the U.S. The American economy got so flooded with dollars that it needed an outlet. The outlet came in form of a borrowing and spending overdo. The U.S. financial system works that whatever loans or schemes they offer, hides the flaws and risks with such erudition that a borrower is lured to buy them.

The two main reasons that attracted the borrowers were low interests and huge funds that helped easy loans for people. With such attractive promises, people took more and more loans to build houses and invest money. Since there was surplus amount of money in the banks and adding more trouble to that, all the terms were relaxed and the demarcation between the prime and subprime loans came at par. Banks merely looked for borrowers irrespective of their background, returning capacity and poor credit history. Borrowers were lured with incentives and bonus offers. The interest rates were also kept low initially and were meant to increase after the initial period. Despite of these borrowers continued to buy even those with a poor credit history (called NINJA - No Income No Job No Assets). The house prices started to ascend due to huge investments. The overindulgence proved a good time for all. The lenders and borrowers believed that the interest rates that would increase gradually or the soaring house prices will help in recovering of the loans. In case the borrower is unable to pay the interest, the houses could be sold off until the prices are soaring.

Thereafter the things started to occur just opposite the way it was thought to happen. Thus complication started when the overbuilding of houses caused a decline in the prices thereby grasping the returning capacity of the borrowers. The borrowers had no money to repay the loans and meanwhile the interest rates continued to soar. The situation became worst when the loan amounts exceeded the total cost of the house and gave way to recession.

Recession in economics means a general slowdown in economic activity in a country over a sustained period of time, or a business cycle contraction. During recessions, many macroeconomic indicators vary in a similar way. Production as measured by Gross Domestic Product (GDP), employment, investment spending, capacity utilization household incomes and business profits all fall during recessions.

During recession subprime loans came under immense limelight and turned out to be an excellent option for the banks. Many big investors bought such loans from the original lenders thus helping lenders with fresh funds to rise again. These investors were not only from America but also from the other parts and as a result the phenomenon remained no more confined to the U.S. The limelight of the loans remained until the prices soared. But as soon as there saw a decline, loans became unbeneficial and risky. Investors from all over the world who took loans faced major losses. These losses trickled down to other banks that were in chain with the international banks of America who formed the backbone of many banks. As the banks were left with no money, the major industries and companies worldwide that depended on loans from these banks for their activities faced closure. The recession became hazardous for the world market soon.

The sources of recessions have been one of the enduring areas of research in economics. There are a variety of reasons recessions take place. Some are associated with sharp changes in the prices of the inputs used in producing goods and services. For example, a sharp increase in oil prices can be a harbinger of a coming recession. The reason being, as energy becomes expensive, it pushes up the overall price level, leading to a decline in aggregate demand. A recession can also be triggered by a country's decision to reduce inflation by employing con-reactionary monetary or fiscal policies. When used excessively, such policies can lead to a decline in demand for goods and services, eventually resulting in a recession.

Some recessions, including the current one, are rooted in financial market problems. Sharp increases in asset prices and a speedy expansion of credit often coincide with rapid accumulation of debt. As corporations and households get overextended and face difficulties in meeting their debt obligations, they reduce investment and consumption, which in turn leads to a

decrease in economic activity. Not all such credit booms end up in recessions, but when they do, these recessions are often more costly than others. Recessions can be the result of a decline in external demand, especially in countries with strong export sectors. Adverse effects of recessions in large countries such as Germany, Japan, and the United States are rapidly felt by their regional trading partners, especially during globally synchronized recessions.[28]

2) HOW DOES SECURITISATION CATALYZE RECESSION?

The financial crisis that arose in the recent past can be attributed to a multiple of reasons but one of them for sure centers on Securitization.

- Firstly, Securitization enhances market liquidity by converting illiquid assets on the balance sheets of originators into marketable securities. Further, since the said securities are backed by assets, the ease at which they are liquidated is relatively high thus contributing to the creation on market liquidity thereby providing the banks with an opportunity to attract more borrowers. Moreover, the fees paid to the originators for carrying out various responsibilities in the securitisation chain, proved to be an additional incentive for them to securitize more and more[29]. However this will give rise to a situation where most of the prime borrowers who already had loans, the originators will lower the lending standards to attract as many new borrowers as possible which consequently included sub-prime ones[30]. The originators not only relaxed the criterion for advancing loans, they will also create loans which initially looked attractive but were actually toxic for the borrowers.[31] As a result, the overall fragility of the financial system increased and the seeds of recession in the credit cycle will be sown slowly.

[28] www.imf.org/external/pubs/ft/fandd/2009/03/pdf/basics.pdf
[29] *Éric Tymoigne*, Securitization, Deregulation, Economic Stability, and Financial Crisis, Part I: The Evolution of Securitization, Working Paper No. 573.1, 18 (2009)
[30] *Hyun Song Shin*, Securitisation and Financial Stability, 119 The Economic Journal 309,331 (2009)
[31] Supra n. 10

- Secondly, the originators might increasingly adopt the "originate and distribute"[32] model i.e. they will created loans which they had no plan to retain on their balance sheets. This model will ultimately induced a reckless approach in assessing the quality of the loans with the originators being largely unconcerned about the quality of the loans and underlying assets that were eventually going to be securitised.[33] These inadequately evaluated loans termed as "hot potatoes"[34] were passed through the financial chain to unsuspecting investors as each party relied on others to investigate the loans comprehensively.[35] However, what is pertinent is that securitization will not eliminate the risk or completely transfer the risk down the financial chain; it issued liabilities backed by the "hot potatoes" to which all the intermediaries in the securitization process being exposed.

- Thirdly, the manner in which the credit rating agencies executed their responsibility of assessing the securities[36] was probably one of the most significant factors that brought about the financial crisis. The rating agencies neither examined the credit worthiness of the borrowers nor the underlying assets that backed the securities while judging their credit risks. Owing to the unavailability of details of the securities, the agencies used proxy data[37] on default rate and recovery rate of to arrive at a classification of the securities. Further, the conflict of interest created due to the commissions paid to the agencies by the security issuers and the level of competition between, induced the agencies to adopt sloppy methods of rating securities.[38] On the other hand, the SPE approached only specific agencies in order to obtain favorable ratings.

[32] Great Britain: Parliament: House of Commons: Treasury Committee, *Financial stability and transparency: sixth report of session 2007-08,* The Stationery Office, 18 (2008)
[33] *Éric Tymoigne*, Central Banking, Asset Prices and Financial Fragility, *Taylor & Francis*, 117 (2009)
[34] *Hyun Song Shin,* Securitisation and Financial Stability, 119 The Economic Journal 309,331 (2009)
[35] *Jane W. D'Arista,* The Evolution of U.S. Finance: Restructuring Institutions and Markets, M.E. Sharpe,275 (1994)
[36] *Gerard Caprio, Asli Demirguc-Kunt, Edward Kane,* The 2007 meltdown in structured securitization : searching for lessons, not scapegoats, 4756 Policy Research Working Paper Series, World Bank, 15 (2008)
[37] Éric Tymoigne, *Securitization*, Deregulation, Economic Stability, and Financial Crisis, Part I: The Evolution of Securitization, Working Paper No. 573.1, 18 (2009)
[38] *Ibid.*

As a result, the very rationale behind involving credit agencies in the securitization process was defeated with securities being graded AAA even though they were backed by junk financial claims. The inappropriate rating left the investors with unsound evaluation of credit risks involved in the securities which offered a false sense of security to the investors who willingly took on the risks.[39] It is certainly arguable that investors, as reasonable men involved in financial system, would be apt judges of risks that they undertook. However, as explained by Tymoigne, " investors judge risk from a social rationality where they chose to follow the majority.[40] Besides, the complete lack of transparency left the creditors with no means of evaluating the risks since it was believed that releasing information would bring about selective investments that would reduce the market liquidity".[41]

- Fourthly, the various counterparties in the securitisation process have become increasingly interdependent for cash flow which has increased the systemic risk considerably.[42] This implies that investors depend on the SPE to sell the securities to them, the SPE depends on the originator to provide assets and the originator ultimately depends upon the borrowers. Yet, what actually worsened the scenario was the growing opacity[43] or uncertainties of transactions between the counterparties rendered them incapable of judging their own financial strength since they were unaware of the actual counterparties or the effect of default by any one of them. This threatened the financial stability since the banks become reluctant to lend to each other. [44]

Thus the above mentioned points give us an indication that the way Securitisation was actually implemented in the American economy, it can to a certain extent catalyze recession. The

[39] *Barbara Ridpath, Arvind Sivaramakrishnan*, Securitisation Must Take the Centre Stage Again, (2010) (retrieved from http://www.icffr.org/Research/Comments/September-2010/Securitisation-Must-Take-the-Centre-Stage-Again.aspx)
[40] Supra n. 18
[41] *Marco Pagano and Paolo Volpi,* Securitization, Transparency and Liquidity, 210 CSEF Working Papers, Centre for studies in Economics and Finance, 2 (2008)
[42] *Ibid.*
[43] *Joseph R. Mason & Joshua Rosner*, Where Did The Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities And Collateralized Debt Obligation Market Disruptions, 5, (2007)
(retrieved from http://www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf)
[44] *Ronald McKinnon, Stanford University*, Zero Interest Rates and the Fall in U.S. Bank Lending, 1 (2009)
(retrieved from http://www.stanford.edu/~mckinnon/papers/zero_interes_in_bank_lending.pdf)

scrutiny reveals that starting from the originator to the SPE to the credit rating agency, everyone was concerned more about their share in the great American money fiesta rather than their actual duties of guiding investors and managing finance. In simple, terms what was meant to improve financing and funding of welfare improving assets became an arena for strategic and systematic financial gambling. Like the captain of Titanic, who did not see the iceberg and refused to accept the idea that the ship could ever go down, the banks foolishly believed that that the bubble could only expand but it inevitably burst and the world sank into recession.

Securitisation and its present situation in India

Securitisation is one of the latest financial innovations in Indian markets. It is still in its nascent stage, with securitized assets as low as about 2% of all debt outstanding. In December 2002, a legal frame work was provided for securitization through the "securitization and reconstruction of financial assets and enforcement of security interest Act", 2002 which became effective from June 21, 2002. The growth in the Indian securitisation market has been largely fuelled by the repackaging of retail assets and residential mortgages of banks and FIs. This market has been in existence since the early 1990s, though has matured significantly only post-2000 with an established narrow band of investor community and regular issuers. According to Industry estimates, the structured issuance volumes have grown considerably in the last few years; though still small compared to international volumes. Asset backed securitisation (ABS) is the largest product class driven by the growing retail loan portfolio of banks and other FIs, investors' familiarity with the underlying assets and the short maturity period of these loans. The mortgage backed securities (MBS) market has been rather slow in taking off despite a growing housing finance market due to the long maturity periods, lack of secondary market liquidity and the risk arising from prepayment/reprising of the underlying loan.

Global perspective of securitisation: an over-view

Securitisation has emerged as one of the dominant means of capital formation throughout the world, particularly in US, Canada, Europe, Latin America and South East Asia. Each year, trillions of dollars of securitization transaction are structured by a wide range of entities like financial institutions, auto financiers, leasing companies, credit issuers, infrastructure and insurance companies, government and local authorities. There is a lot of scope for further growth in the securitization of other assets like credit cards, trade credits, receivables, auto loans and lease receivables etc.

▪ *RESEARCH HYPOTHESIS*

1. The securitization of loan facilitates the original lender thinking that he is sticking to an opportune, favorable and suitable position which will assist him to transmit the risk to the other investors and with this process the originator can get away capital sufficiency requirements. But the hazard which securitization wants to avoid does not disappear from the financial system altogether. For this reason the risk does not entirely move out from the system on the whole and in the natural course of financial market the same troubles again. Therefore the disease that securitization wants to cure remains as it is and merely changes its position from one to another actor in the market.

▪ *RESEARCH QUESTIONS*

1. *What exactly is the **purpose behind the creation of securitization**; and whether the market through the present practice of securitization has lived up to that purpose?*
2. *Whether securitization **increases liquidity or catalyzes recession**?*
3. *What would be the **role of the market regulators** in such a situation?*
4. *Whether securitization is one of the **causes behind the global financial crisis** and to what extent it contributed to the occurrence of such a crisis?*

5. *What are the impacts of* ***global financial crisis on different segments like investment, information technology, foreign exchange, stock markets and the Indian economy as a whole****?*
6. *What could be the* ***possible suggestions for overcoming future disasters****?*

▪ *RESEARCH METHODOLOGY*

The nature of the present work is doctrinal in nature. This research is mainly based and carried on the basis of legal proportions, doctrines, juristic opinions and secondary sources of data. It would be carried on by analyzing the existing statutory provisions, legal propositions and cases by applying the reasoning and analytical approach. The entire work is descriptive and exploratory in nature and is carried on with a systematic approach. As mentioned earlier, the research is based on the comprehensive study of both *primary* as well as *secondary sources*. Primary source includes the Statutes, Codes, Rules, Regulations, Bye-laws, Circulars, Notifications, and etc. The Secondary resource includes different works of various eminent authors and jurists, scholarly articles, books, law journals, committee reports, commentaries; case notes and other relevant materials from internet.

The researcher has thereby tried to go through all those committee reports, guidelines, and circulars etc. that are related to this topic. Thereafter has made an attempt to rationalize those views, opinions and trace those unexplored areas and burning issues which can be or should be researched upon which would be the base of this research at a later stage.

▪ *STRUCTURE OF THE THESIS*

The researcher would like to proceed with the present research work in a systematic, methodical and orderly manner. As of now the concerned thesis will be tentatively outlined

under the following chapters. As the area is a very broad, complicated and technical the researcher has tried his utmost level best to deal with different areas in separate chapters.

I. In the **First Chapter** the researcher would like to introduce term 'Securitisation'. It will deal with the concept, its structure, purpose and its kinds. In the said chapter the researcher would like to elaborate the significance, importance and the benefits that arise out of the process of Securitisation as a whole. This chapter is basically the gateway to the entire thesis. It will give talk about the scope or the magnitude of the entire notion of Securitisation. The aim of this chapter will be to introduce the topic and it will also endeavor to give an appropriate background to my research topic.

II. The **Second Chapter** of the thesis is supposed to give an insight on the legislative framework of Securitisation. This is a very important chapter for the thesis because it proceeds to assess the scheme of the SARFAESI Act. It will talk through certain important issues like Creation of security interest, asset reconstruction, the incorporation, registration of special purpose companies, funding of securitisation etc. Moreover, the researcher would also touchdown the issue of Non Performing Loans.

III. The **Third Chapter** will talk about the problem of Non-Performing Loans which happens to be a global problem and has attributed most to the outbreak of financial crisis. It lays out the present structure of the Indian banking sector, while also providing a quick overview of the policy of "social control" leading to nationalization of some private commercial banks in India. It is important to understand the policy of social control because it is often argued that the era of "social control" that led to the policy of "directed credit" was one of the primary reasons for the buildup of NPAs in the Indian banking sector.[45] This chapter not only deals with the said

[45] Several scholars, most notably by Alexander Gerschenkron, have viewed government ownership of banks with some optimism. See generally Alexander Gerschenkron, Economic Backwardness in Historical Perspective: A Book of Essays (Harvard University Press 1962) (arguing that in countries like Russia, there was severe scarcity of capital, which coupled with dismal standards of honesty in business meant that only the government could fulfill the function of providing industrial credit). This school of thought thus focuses on the role of government in controlling finance, and boosting economic growth. These ideas became the hallmark of economic policy in Asia and other developing regions in 1960s and 1970s. It seems that, in India at least, post-nationalization of banks in 1969,

problem exhaustively with regards to India but some other countries like China, Japan, USA, Asia etc.

IV. In the **Fourth Chapter** the researcher feels it very imperative to discuss the reasons behind financial crisis like the securitisation practices, inaccurate credit rating, poor regulation, speculation etc. This chapter will stress upon the impact of such a situation upon Indian Capital Market. It will also highlight on the impact that would be created upon certain other fields like information technology, investment, real estate, stock market, foreign exchange, exports, unemployment etc.

V. The **Fifth Chapter** of the thesis specifically concentrates on the role of securitization in catalyzing recession. The researcher would try to talk through the history of market failure and government rescues, the events that gave birth to the causes and the events that led to this great recession.

VI. Proposed reforms will form the basis of **Chapter Six.** It will include recommendation and future research suggestion.

VII. The final chapter that is **Seventh Chapter** will be the Conclusion of the thesis. The researcher will in a very brief way conclude the entire research work that he has undertaken.

▪ *RESEARCH PLAN*

The researcher would like to conduct the research work with an approach which would be exploratory in nature clinging to aspects of both qualitative and quantitative study. The researcher will definitely go for reviewing, analyzing and exploring the existing work that has been carried out in this field. Using qualitative analysis persons who by the virtue of their jobs are able to give valuable insight into the research shall be interviewed and their inputs taken will

competitive environment was adversely affected. The profitability of banks started declining and non-performing assets increased.

be assessed and evaluated. Study of select cases/instances and observation given by Government (Central as well as State), Committee Reports, Circulars, Policies, Guidelines and Declarations will be critically analysed. The research would not be possible if the researcher would not acknowledge the fact that without the extensive use of library and internet sources the research would be possible and if though possible will not be worthful. The researcher would also like to organize or if any opportunity comes in his way would definitely involve and participate in general discussions or debates which will definitely help him to contribute to that extra level which will undoubtedly improve the quality of the research work.

The researcher proposes to finish the work within the period of 24 months; out of which the first five months have been kept for collection of the relevant research materials; and two months for preparation of each chapter. The remaining three months will be utilized for the finalization of the chapters and other necessary works.

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